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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

HCL PARTNERS LIMITED PARTNERSHIP, on behalf of itself and all others similarly situated, Plaintiff, v. LEAP WIRELESS INTERNATIONAL, INC., S. DOUGLAS HUTCHESON, AMIN I. KHALIFA, GRANT A. BURTON, MICHAEL B. TARGOFF, JOHN D. HARKEY, ROBERT V. LaPENTA, and PRICEWATERHOUSECOOPERS, LLP, Defendants. KENT CHARMICHAEL, Individually and on behalf of all others similarly situated, Plaintiff, v. LEAP WIRELESS INTERNATIONAL, INC., *et al.*, Defendants.	LEAD CASE NO. 07-CV-2245 (BTM) (NLS) Consolidated with Case No. 08-CV-0128 (BTM) (NLS) CLASS ACTION **DEFENDANT LEAP WIRELESS INTERNATIONAL, INC.'S MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF MOTION TO DISMISS THE CONSOLIDATED CLASS ACTION COMPLAINT** Hearing Date: November 21, 2008 Hearing Time: 11:00 a.m. Courtroom: 15 The Honorable Barry Ted Moskowitz, United States District Court Judge No Oral Argument Unless Requested By Court

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MEMORANDUM OF POINTS AND AUTHORITIES

This is a securities class action lawsuit against Leap Wireless International, Inc. ("Leap"), a San Diego-based wireless communications carrier, six of Leap's officers and directors, and Leap's independent, outside auditor, PricewaterhouseCoopers, LLP ("PwC"). This Motion to Dismiss is brought on behalf of Leap. Leap joins in the Motion to Dismiss filed on behalf of its officers and directors (the "Individual Defendants").

I. INTRODUCTION AND SUMMARY OF MOTION

This lawsuit was filed on speculation shortly after Leap announced, on November 9, 2007, that it would restate its financial statements to correct accounting errors, including both understatement and overstatement of revenues. Consolidated Class Action Complaint ("Compl.") ¶ 139. The errors had been discovered during an internal, management-led review of Leap's service revenue and forecasting, and were "not attributable to any misconduct by Company employees." *Id.* Nonetheless, before Leap could even file its restatement ("Restatement") on December 26, 2007, lawsuits were already piling up accusing Leap and its directors and officers of "securities fraud."

Plaintiff filed the Consolidated Complaint before this Court, however, seven months *after* the Restatement; thus, it presumably reflects Plaintiff's best efforts to investigate and identify any sinister explanation for the accounting errors. Having found no evidence of fraud (as there was none), Plaintiff seeks refuge in an illusion of substance – a 105-page Complaint that, despite its length, manages largely to ignore Leap's own explanations for the accounting errors. Instead, Plaintiff strains to construct fraud theories based on vague comments by anonymous former consultants and conjectural interpretation of unspecified internal reports. These allegations come nowhere close to pleading a claim of securities fraud.

This action typifies the kind of speculative lawsuit that Congress sought to bar at the pleading stage under the Private Securities Litigation Reform Act ("PSLRA") by establishing very rigorous pleading requirements. Under the PSLRA, Leap cannot be held answerable for alleged securities fraud absent particular allegations of *fact* supporting a "strong inference" that Leap's managers misrepresented Leap's financial reports with a fraudulent intent to deceive investors. 15 U.S.C. § 78u-4(b)(2). The Supreme Court has held that allegations sufficient to support a "strong inference" must be "cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504-05 (2007). Plaintiff's allegations do not support any inference of fraudulent intent, let alone a "strong inference." The many fatal pleading defects here include the following:

First, it is black letter law that a restatement does not signal any fraud. A restatement is issued to correct *errors* under Generally Accepted Accounting Principles ("GAAP") and is fully consistent with a good faith, albeit mistaken, effort to produce accurate financial statements. *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002) ("[T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter."). In this case, the fact that the errors understated revenue in some periods counters any inference of fraudulent intent: Why would Leap's managers commit fraud in order to *understate* revenue? Apparently seeking to avoid this inconvenient question, Plaintiff artfully crafted the alleged Class Period to start in the *middle* of the Restatement: Although the Restatement included fiscal years 2004, 2005, 2006 and the first two quarters of 2007, the alleged Class Period starts on August 3, 2006 (when Leap reported on its second quarter of 2006) and ends on November 9, 2007 (when the Restatement was announced) – thus cutting off the earlier two and half years when the accounting errors understated Leap's revenue.

Second, the fact Leap identified material weaknesses in internal controls that led to the Restatement does not plead *prior* knowledge or concealment of those weaknesses. *In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1158 (C.D. Cal. 2007) (restatements are generally accompanied by identification of "a lack of effective controls"). Again, Plaintiff's own allegations counter any fraud claim: Leap had disclosed *other* material weaknesses in its accounting, financing and tax staff well into the alleged Class Period, through year-end 2006. Compl. ¶¶ 79, 98. This negative disclosure is inconsistent with Plaintiff's contention that Leap sought to conceal material weaknesses. Moreover, as of year-end 2006, when Leap believed that it had resolved its staffing problems and that its internal controls were "effective," Leap's auditor, PwC, in its professional judgment, agreed. *Id.* ¶¶ 111, 156. Thus, Plaintiff's fraud theory irrationally assumes that Leap and its auditor first conspired to hide *some* material weaknesses while disclosing *others*, and then started concealing material weaknesses altogether. Plaintiff alleges no facts to support this patently implausible conspiracy theory.

Third, Plaintiff's references to unspecified internal reports and vague comments by "Confidential Witnesses" ("CWs") do not plead that any Defendant had knowledge of any misrepresentation of financial results or material weaknesses. Plaintiff does not specifically identify a single alleged report – no specific "minutes report," "reconciliation report," or "SOX testing report" – or explain how or when any such report demonstrated a financial reporting error or material weakness. Nor does Plaintiff identify any specific report provided to any Defendant.

Likewise, the alleged CW comments about delayed "hot-lining" and "short cuts" are vague and do not even demonstrate inaccurate accounting, much less fraud. Indeed, the fact that Leap hired consultants to reconcile accounts and test internal controls evidences Leap's efforts to produce accurate financial reports, not to deceive investors. If Plaintiff or the CWs do not like how Leap's managers handled issues that may have been raised, so be it. That is merely a criticism of management, not an allegation of fraud. The securities laws are not "a scheme of investor's insurance," but require pleading and proof of *fraud* in connection with the purchase or sale of securities. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341, 345 (2005); 15 U.S.C. § 78j(b). There is no fraud alleged here.

II. STATEMENT OF FACTS AND ALLEGATIONS

A. Leap and the Individual Defendants

Leap is a public company, incorporated in Delaware and headquartered in San Diego. Compl. ¶ 20. Leap provides wireless communications service in the United States under the Cricket® and Jump® Mobile brands to more than three million subscribers. *Id.* Leap filed for bankruptcy under Chapter 11 in April 2003, reorganized, and emerged in August 2004, two years before the start of the alleged Class Period (August 3, 2006-November 9, 2007). *Id.* ¶¶ 34, 141.

The "Management Defendants" during the Class Period are Doug Hutcheson (CEO, interim CFO for part of the time, and director), Amin Khalifa (then CFO), and Grant Burton (then Controller and Chief Accounting Officer). *Id.* ¶¶ 21, 23, 24. The "Audit Committee

Defendants" are three independent, non-officer directors, Michael Targoff, John Harkey, and Robert LaPenta. *Id.* ¶¶ 26-28. Plaintiff also names Leap's independent auditor, PwC. *Id.* ¶ 34.

B. Leap's Unlimited Wireless Service Business Model

Leap's business model is built on providing wireless cellular service to underserved customer segments, including younger people and others with lower incomes. As Plaintiff alleges, Leap does not require credit checks or long term contracts. *Id.* ¶¶ 51, 54. Consistent with its business model, Leap's revenue recognition policy is conservative: "*service revenues are recognized only after services have been rendered and payment has been received.*" *Id.* ¶ 55. While Leap's subscribers may buy pre-paid minutes for service (Jump Mobile®), the vast majority buy unlimited service for a flat monthly service fee (Cricket®). *Id.* ¶¶ 51, 67, 70. Under the unlimited service model, minutes do not matter, as Plaintiff alleges. *Id.* ¶ 67 ("Leap was entitled to collect a flat fee on Cricket accounts regardless of the number of minutes used").

Plaintiff confusingly alleges that Leap's Cricket® subscribers "pay-in-arrears" for unlimited service (*id.* ¶¶ 4, 52, 55), but acknowledges elsewhere that they "pay-in-advance" for unlimited service (*id.* ¶¶ 77, 78, 102). If Plaintiff had read its quotations from Leap's SEC filings more carefully, Plaintiff would have seen that Leap changed its model in May 2006 so that new and returning customers "pay-in-advance" for unlimited service. *See id.* ¶ 102 at 53, lines 11-12 ("Starting in May 2006, all new and reactivating customers pay for their service in advance."); *id.* ¶ 107 at 55, lines 25-27. Thus, during the alleged Class Period, Leap's subscriber base was in transition from "pay-in-arrears" to "pay-in-advance." This transition contributed to, and explains, some effects of the Restatement. *See id.* ¶¶ 141, 147, 149.

C. Leap's Disclosure of Material Weaknesses

In May 2005, Leap identified a material weakness in its internal controls over financial reporting which it reported to investors for a year and half, well into the alleged Class Period. *Id.* ¶¶ 79, 112. Plaintiff is forced to acknowledge this disclosure – even though it contradicts the contention that Leap sought to conceal material weaknesses. *Id.* ¶ 79. Leap's earlier identified material weakness arose out of its bankruptcy when, not surprisingly, Leap experienced "staff turnover and an associated loss of Company-specific experience within its accounting, financial reporting and tax functions." *Id.* This made it difficult for Leap "to maintain a sufficient complement of qualified staff in its accounting and finance department." *Id.* Leap's management determined that this control deficiency rose to the level of a "material weakness," which Leap dutifully disclosed.

Plaintiff misuses the term "material weakness" to mean every criticism or possible deficiency in internal controls that might have come to the attention of Leap's managers or PwC. *E.g.*, Compl. ¶¶ 48, 49, 75. In fact, "material weakness" is a technical term of art under professional auditing standards which, in long form, means "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the … financial statements will not be prevented or detected on a timely basis." *See id.* ¶ 153; PCAOB Auditing Standard No. 5 ("AS 5"), App. A7 (defining "material weakness"). Lesser deficiencies in internal controls are not "material weaknesses," and may not be particularly important to a company's overall ability to produce reliable financial reports. *See* AS 5 ¶¶ 20, 24, 36 (considerations in an auditor's assessment of internal controls). While SEC regulations implementing Section 404 of the Sarbanes-Oxley Act (15 U.S.C. § 7262), require a company to report on whether its internal controls over financial reporting are "effective," there is no law, rule, or regulation requiring companies to report the existence of mere deficiencies in internal controls that do not rise to the level of a "material weakness." 17 C.F.R. § 229.308(a)(3).

During the alleged Class Period, Leap continued working to remediate its material weakness in accounting and finance personnel. By year-end 2006, after hiring a significant number of qualified employees in 2005 and 2006 (which Plaintiff does not dispute), Leap's management believed that Leap had successfully remediated the weakness. Compl. ¶ 112.[1] In

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[1] Plaintiff does not dispute Leap's report of the new hires or their roles and qualifications. Compl. ¶¶ 111, 112. As Leap reported: "These include the following positions:

- a new vice president, chief accounting officer hired in May 2005,
- a new director of tax to lead our tax function hired in June 2006,
- a new executive vice president, chief financial officer hired in August 2006,
- a new assistant controller hired in December 2006,

February 2007, Leap reported its 2006 year-end results, including management's determination that Leap's internal controls over financial reporting were "effective." *Id.* Leap's auditor, PwC, issued its professional audit opinion agreeing with management's determination. *Id.* ¶ 156.

D. Leap's Second Quarter 2007 Stock Price Drop and "Churn"

After Leap reported its second quarter 2007 results on August 7, 2007, Leap's stock price dropped. Although Leap's financial results were positive, its stock is volatile, as Plaintiff's stock price chart graphically illustrates. *Id.* ¶ 2. Plaintiff speculates that Leap's prediction of third quarter churn in the range of 4.9%-5.4% disappointed the market. *Id.* ¶¶ 134, 137. In Leap's business, "churn" is a measure of customer turnover that takes into account the net number of customers who disconnect over a relevant time period. Leap routinely reports churn in its SEC filings, as Plaintiff's allegations indicate. *E.g.*, RJN, Exh. G at 32 (2Q07 Form 10-Q).[2]

Plaintiff strains to characterize Leap's forecast of third-quarter churn as a "partial disclosure" of the "Truth" designed by Defendants to "soften the blow" of the coming Restatement (which was then months away and utterly unpredicted). Compl. ¶ 135.[3] As discussed below, however, Plaintiff's misrepresentation theory has no factual basis and is frankly incoherent. Plaintiff never even mentions whether the churn forecast was right or wrong (it was right, *see* note 7, below). Moreover, Plaintiff's own allegations show that churn was never restated. *Id.* ¶ 139 ("the expected adjustments do not impact previously reported results for net customer additions or churn").[4] This means that Plaintiffs cannot identify any false statement of churn or allege a misrepresentation claim based on churn. This also means that Leap's

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- a new director of financial reporting hired in December 2006, and
- a number of other new accounting management personnel hired since February 2005." *Id.* ¶ 112.

[2] "Churn, which measures customer turnover, is calculated as the net number of customers who disconnect from our service divided by the weighted-average number of customers divided by the number of months during the period being measured." *Id.*

[3] Plaintiff is attempting to manufacture a hook to claim the August 2007 stock price drop as part of any alleged "damages" to the stock price based on the later Restatement.

[4] A table in the Restatement shows how several financial metrics were affected. *See* RJN, Exh. B at 53 (2006 10-K/A). Comparing the metric "Churn" with a similar chart for year end 2006 (RJN, Exh. F at 60 (2006 10-K)) shows that Leap's reported Churn was not affected.

subscriber count, which is part of the churn calculus (*see* note 3), was not affected by the Restatement – a fact that strongly undermines Plaintiffs' theory that revenue was overstated because the subscriber count was supposedly overstated.

E. Leap's 2007 Restatement

On November 9, 2007, Leap announced that its management had identified certain accounting errors, and that Leap would restate its financial statements for the years ending 2004, 2005, and 2006, and the first two quarters of 2007. Compl. ¶ 139. Leap reported that the errors were *not* attributable to any employee misconduct. *Id.* As Leap explained, "[t]he restatements are the result of an internal review of the Company's service revenue activity and forecasting process that was initiated by management in September 2007 and are not attributable to any misconduct by Company employees." *Id.* ¶¶ 139, 141 (emphasis added); *see id.* ¶ 147.

Leap explained the nature of the accounting errors and their effects. As Plaintiff alleges, without dispute, some of the same errors caused Leap's revenue to be understated and overstated in different financial reporting periods. *Id.* ¶ 141. Leap also identified "classification errors" that had no effect on revenue, but merely altered the presentation of Leap's balance sheet:

> [1] [**Voluntary Disconnect Error**]: The most significant adjustment relates to the Company's prior accounting for a group of customers who voluntarily disconnected service. These customers comprised a small percentage of the Company's disconnected customers. For these customers, approximately one month of deferred revenue that was recorded when the customers' monthly bills were generated was mistakenly recognized as revenue after their service was disconnected.
>
> [2] [**Timing Errors**]: The Company also identified other errors relating to the timing and recognition of certain service revenues and operating expenses. The effect of the timing errors varied across periods. The error with the largest variation across periods related to the reconciliation of billing system data for pay in arrears customers. This error resulted in an understatement of revenue in 2004 and 2005 and an overstatement of revenue in subsequent periods as the number of pay in arrears customers in the Company's customer base declined.
>
> [3] [**Classification Errors**]: In connection with management's review, errors were also identified relating to the classification of certain components of equipment revenues and cost of equipment.

Id. ¶ 141 (emphasis and bolded language added). On December 26, 2007, Leap filed its restated financial statements. *Id.* ¶ 148. Leap also identified material weaknesses in internal controls over financial reporting that led to the errors. *Id.* ¶ 149; *see id.* ¶¶ 152-53. Leap recognized that, in hindsight, "the design of controls over the preparation and review of the account reconciliations and analysis of revenues, costs of revenues and deferred revenues did not detect the errors in revenues[.]" *Id.* ¶ 149. A contributing factor included error in testing changes to the billing system when Leap transitioned to the pay-in-advance service. *See id.* ¶¶ 149, 152-53.

Three data points in Leap's Restatement-related disclosures bear special note. First, the largest error in the category of Timing Errors concerned revenue for pay-in-arrears customers and resulted in *understatement* of revenue in 2004 and 2005, which Plaintiff does not dispute. Plaintiff's contention that Defendants designed the accounting errors in order to overstate Leap's results makes no sense given this fact. Plaintiff's gerrymandering of the Class Period definition does not avoid this fundamental flaw in its fraud theory. Second, even within Plaintiff's hand-tailored Class Period, the accounting errors still *understated* net income for the second quarter of 2007 by 66.31%, as illustrated in Plaintiff's Restatement chart. *Id.* ¶¶ 3, 151. Again, this fact contradicts Plaintiff's claim that Defendants were deliberately overstating revenue. Third, the Voluntary Disconnect Error involved only a "small percentage" of customers for whom revenue was mistakenly recognized for one month after they disconnected. Plaintiff ignores, but does not dispute, this explanation. Instead, Plaintiff tries to manufacture a different explanation for the revenue overstatement but, not surprisingly, is unable to allege facts that support it.

F. Plaintiff's Fraud Theories

Cutting through the verbiage in the Complaint, Plaintiff appears to claim that Defendants made three kinds of fraudulent misrepresentations in order to deceive Leap's investors:

- Revenue: Plaintiff claims that Leap fraudulently overstated revenue, as corrected in the Restatement. While Plaintiff characterizes this claim in dozens of different ways, the most frequent formulation is that Leap recognized revenue in violation of its stated policy "before payment was received" and/or "after the subscriber's wireless service had been terminated." *Id.* ¶¶ 78, 90, 103, 123. A reader may guess that "before payment was received" alludes to the Timing Error for pay-in-arrears subscribers, although Plaintiff does not say so. Plaintiff spills most of its ink trying to develop theories that Leap fraudulently recognized revenue for terminated subscribers (while avoiding reference to the Voluntary Disconnect Error).

- Internal controls: Plaintiff claims that Leap fraudulently misrepresented internal controls by failing to make earlier disclosure of the material weaknesses identified in the Restatement, and by opining, that internal controls over financial reporting were "effective" as of year-end 2006. *Id.* ¶¶ 98-100, 112-116.

- Churn: Plaintiff contends that Leap and Defendant Hutcheson misrepresented Leap's churn in the first and second quarters of 2007. *Id.* ¶¶ 120-121, 134-35. Plaintiff's theory of misrepresentation defies any coherent explanation. Plaintiff states that Leap somehow "double counted" subscribers, but that this "double counting" was remedied in "subsequent periods," but even so resulted in "double counting" revenue "which was the basis for the eventual" Restatement. *Id.* ¶ 121. Say again? This "double" talk is not explained by Plaintiff's cross references to any of the CWs' alleged comments. *Id.*

Plaintiff walks through selective quotations from Leap's quarterly and annual SEC filings, earnings reports, and analyst conference calls during the alleged Class Period, occasionally calling out the names of Individual Defendants whose comments were quoted or who signed SEC filings. *See id.* ¶¶ 73-137. Plaintiff claims that some of the quotations (mostly leaving the reader to guess which ones) misrepresented revenue, internal controls, or churn. In an attempt to demonstrate that Leap made the alleged misrepresentations knowingly or deliberately, while possessing contrary contemporaneous information, Plaintiff relies on unspecified internal reports and vague comments attributed to CWs, discussed below.

Alleged Evidence of Fraudulent Intent

"Minutes Reports": The Complaint is littered with references to so-called "Minutes Reports." "Minutes Reports" supposedly were created by CW#1 at Leap's request, and reported subscriber usage of minutes. *Id.* ¶¶ 10, 25. CW#1 was an IT consultant who worked for Leap in 2005, long before the Class Period began. *Id.* Plaintiff contends that "Minutes Reports" were a "red flag of active Cricket accounts which showed no usage of Leap's services," and therefore "undeniable evidence that the customers in question … had terminated their Leap service." *Id.*

¶¶ 10, 45. Plaintiff catapults to an unfounded conclusion that "Minutes Reports" therefore show that Leap "was recording and recognizing revenue for subscribers that had terminated their wireless services." *Id.* ¶¶ 25(a), 45, 47. Plaintiff claims that CW#1 and CW#3 distributed "Minutes Reports" to the Management Defendants (*id.* ¶¶ 45, 47), among others, and that "improper revenue recognition" practices reflected in the "Minutes Reports" were discussed at management meetings and provided to PwC. *Id.* ¶ 13.

Given Plaintiff's allegation that Leap had three million customers and that the "Minutes Reports" reported customer airtime usage, it is impossible to imagine how even the most attentive reader could divine any revenue misstatement from a "Minutes Report." *Id.* ¶¶ 20, 61. The notion is particularly implausible given that Leap's business model is based primarily on *unlimited* usage in which minutes are irrelevant as a gauge of revenue, as Plaintiff admits. *Id.* ¶ 67. Plaintiff does not identify a single, specific "Minutes Report," much less one that was actually provided to, or reviewed by, any Defendant. In any event, Plaintiff offers no explanation of why, even if some subscribers were not using minutes, this would mean that Leap was improperly recognizing revenue. Indeed, service might be suspended until a late payment was received, or a subscriber who paid in advance might stop using the service before the prepaid period expired.[5] Plaintiff never explains why review of "Minutes Reports" would alert a Defendant that revenue was being improperly recognized or, if so, in any material amount.

Account Reconciliation Reports: Plaintiff alleges that CW#2, a consultant, managed a cash revenue and reconciliation team that, among other things, identified failures to reconcile service revenue with cash received in the bank. *Id.* ¶ 11. The alleged "discrepancies" were documented in cash reconciliation reports, reported to Management Defendants (*id.* ¶ 46), and discussed at regular management meetings attended by CW#2 and CW#3. *Id.* ¶¶ 11, 13, 25, 87.

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5 *See*, *e.g.*, RJN, Exh. B at 26 (2006 10-K/A) (handsets are disabled three days after payment is due and reactivated if the payment is received within 30 days); RJN, Exh. G at 32 (2Q07 Form 10-Q) (pay-in-advance customers who ask to terminate are disconnected when their pre-paid service ends).

Again, Plaintiff does not identify a single, specific cash reconciliation report. Even if there were occasional "discrepancies" and "failed cash reconciliations," this would hardly be remarkable in a company with more than three million customers. Plaintiff does not identify any instance when any Defendant was informed that a "discrepancy" resulted in an overstatement of revenue, material or otherwise. There is nothing to suggest that any "discrepancy" was ever left unadjusted in Leap's publicly reported financial statements. The allegation that Leap hired a consultant to analyze cash reconciliations, and discussed accounting matters in management meetings, supports an inference that Leap was attempting to produce accurate financial reports.

SOX Testing Reports: Plaintiff alleges that CW#4 and CW#5 were hired as consultants to perform SOX compliance testing. CW#4 allegedly worked for five months in 2006 and CW#5 allegedly worked for three months in late 2006-early 2007. *Id.* ¶¶ 14, 48-49. Plaintiff alleges that these CWs identified internal control "material deficiencies and weaknesses," which they documented in SOX Testing Reports that were uploaded to Leap's Oracle Accounting Database. Plaintiff alleges that the SOX Testing Reports were thereby "provided" to the Management Defendants and PwC in connection with its 2006 audit. *Id.* ¶¶ 25(d), (f), 48-49.

Par for the course, Plaintiff does not identify a single SOX Testing Report, or describe the contents, or what supposed "deficiencies" or "weaknesses" were identified, or when, or any impact on Leap's accounting or publicly reported financial statements, or the factual basis for Plaintiff's conclusory contention that any such Report reflected a "material weakness."

"Short-Cuts": According to Plaintiff, Leap's "Billing System" operated separately from a so-called "Provisioning System" required by the FCC to enable Leap to transfer cell phone users to other service providers. *Id.* ¶ 63. Plaintiff claims that, in order to "keep costs down," Leap encouraged employees to take "short-cuts" by "porting out" subscribers from the "Provisioning System," taking a further step to stop billing, but then "short-cutting" a final step to "remove the record" of the subscribers from the Billing System. *Id.* ¶¶ 14, 25, 48, 66. Plaintiff jumps to the unexplained conclusion that this alleged "short-cut" somehow resulted in continued recognition of revenue from disconnected customers. *Id.* Plaintiff claims that "throughout 2006 and 2007," CW#1 and CW#4 "regularly reported" that this "short-cut" resulted in "discrepancies" in the Minutes Reports, and overstated subscriber totals and service revenues. *Id.* ¶ 67.

Like Plaintiff's other theories, Plaintiff never identifies any instance in which an alleged "short-cut" was taken, or when, or how often. Plaintiff does not explain when or how "short-cuts" led to improper revenue recognition in any amount, material or otherwise. Plaintiff does not identify any specific communication with any Defendant regarding the matter. The allegation that CW#1 and CW#4 reported "short-cuts" "throughout 2006 and 2007" is flatly inconsistent with allegations that CW#1 left Leap in 2005 (*id.* ¶ 45) and CW#4 in 2006 (*id.* ¶ 48).

"Hot-Lining": According to Plaintiff, CW#2 discovered that "subscriber account managers" (who are never identified) delayed "hot-lining" customers in order to inflate subscriber totals. *Id.* ¶ 12. As defined by Plaintiff, "hot-lining" is indistinguishable from the "short-cut," and supposedly refers to removal of subscriber data from the Billing System. *Id.* Like the "short-cut," Plaintiff claims that delayed hot-lining inflated subscriber totals and, somehow inexplicably resulted in Leap continuing to recognize revenue from terminated subscribers. *Id.* ¶¶ 12, 46, 71.[6] Plaintiff claims that CW#2 "reported these problems" to the Management Defendants and others. *Id.* ¶ 46; *see id.* ¶ 25.

Not surprisingly, Plaintiff does not identify any specific instance of hot-lining, or whether, when and how this purported practice led to any improper revenue recognition in any amount, material or otherwise. Plaintiff does not identify any specific communication with any Defendant regarding hot-lining as a problem, or any of the individuals supposedly involved. Nor does Plaintiff quantify any impact on reported revenue, material or otherwise, or explain how or when the alleged practice would have alerted any Defendant to any material inaccuracy in Leap's public financial statements or disclosures.

Motive: Plaintiff alleges that the Management Defendants were motivated to inflate Leap's revenue in order to increase their bonus and stock option compensation (*id.* ¶ 198) and to sell Leap stock at inflated prices (*id.* ¶ 197). Plaintiff's failure to plead fraudulent intent based on these allegations is addressed in the Individual Defendants' Motion to Dismiss at 11-17.

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[6] Plaintiff's description of hot-lining appears to be a mischaracterization of Leap's fully disclosed practice of suspending service three days after a payment is due and reactivating service if the payment is received within 30 days. *See* RJN, Exh. B at 26-27 (2006 10-K/A).

III. ARGUMENT

A. Standard of Review

Under the PSLRA, "plaintiffs in private securities fraud class actions face formidable pleading requirements to properly state a claim and avoid dismissal under Fed. R. Civ. P. 12(b)(6)." *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 2008 WL 3905427, *1 (9th Cir. Aug. 26, 2008). Plaintiffs' pleading burden is higher than under Rule 9(b) which requires plaintiffs to allege with particularity "the circumstances constituting [the defendant's] fraud," including "evidentiary facts." *In re GlenFed Inc. Sec. Litig.*, 42 F.3d 1541, 1547-49, 1548 n.7 (9th Cir. 1994). The PSLRA strengthened the Rule 9(b) principles and provided that any complaint failing to satisfy the higher pleading standards "shall" be dismissed. 15 U.S.C. § 78u-4(b)(3)(A).[7] The PSLRA aimed "to eliminate abusive securities litigation and particularly to put an end to the practice of pleading 'fraud by hindsight.'" *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1084-85 (9th Cir. 2002).

The PSLRA requires Plaintiff to allege "with particularity facts giving rise to a strong inference" that the defendant acted with "the required state of mind" (15 U.S.C. § 78u-4(b)(2)) which, for violation of Section 10(b), is "intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976). In the Ninth Circuit, "intent to deceive" must be alleged "in great detail, [by] facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct." *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 974-75 (9th Cir. 1999). Those facts must "come closer to demonstrating intent, as opposed to mere motive and opportunity." *Id.* "The factual allegations must not only be particular, but also must 'strongly imply [the defendant's] contemporaneous knowledge that the statement was false when made.'" *In re Infonet Servs. Corp. Sec. Litig.*, 310 F. Supp. 2d 1080, 1102 (C.D. Cal. 2003) (emphasis in original).

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[7] Plaintiff is not excused from the most basic pleading requirement – plainly ignored here – that the complaint set forth "a short and plain statement of the claim showing that the pleader is entitled to relief" and that "[e]ach allegation … be simple, concise, and direct." Fed. R. Civ. P. 8(a)(2); (d)(1). Plaintiff's Complaint suffers from profound vagueness and a "puzzle pleading" style condemned by the Ninth Circuit. *See In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1544 (9th Cir. 1994); *see Gold v. Morrice*, 2008 U.S. Dist. LEXIS 43466, at *12-14 (C.D. Cal. Jan. 31, 2008) (dismissing complaint that failed to identify the allegedly false statements clearly, or the factual allegations which supported an inference that statements were misleading); *In re Metro. Sec. Litig.*, 532 F. Supp. 2d 1260, 1277 (E.D. Wash. 2007) ("A complaint whose length and disorganization require opposing counsel and the court to 'root around for actionable claims' does not satisfy Rule 8."); *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1252-53 (N.D. Cal. 1998) (dismissing 86-page complaint under Rule 8).

Under the Supreme Court's 2007 decision in *Tellabs*, when assessing the adequacy of factual allegations of scienter, this Court must consider "not only inferences urged by the plaintiff[s]," but also "competing inferences" and "non-culpable explanations" urged by Defendants that may be "rationally drawn from the facts alleged" (*Tellabs*, 127 S. Ct. at 2504-05) including "inferences unfavorable to the plaintiffs." *Metzler*, 2008 WL 3905427, *7. The "inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent." *Tellabs*, 127 S. Ct. at 2505. The Court must also take into account documents referenced in the Complaint, such as Leap's SEC filings, and other matters that are subject to judicial notice. *Id.* at 2509; *see* RJN.

B. Plaintiff Has Not Alleged Any Fraud Claim Based On Churn

Although the Restatement acknowledges material errors in Leap's prior financial disclosures, it does *not* acknowledge scienter (discussed below), nor any error in Leap's publicly reported churn. In fact, as quoted in the Complaint, the Restatement had no effect on Leap's churn during the Class Period: there was no correction. Compl. ¶ 139, p. 74, lines 26-27 & note 5, above. In order to state a claim under Section 10(b), a plaintiff must plead a corrective disclosure – *i.e.*, that the alleged fraud was disclosed publicly and caused the loss in stock value claimed as damage. *Metzler*, 2008 WL 3905407, * 10. Without a corrective disclosure, there is no causation and no damage. The enabling premise of a securities fraud claim is that investors who buy stock during the Class Period unwittingly pay a price that is artificially inflated by the Defendants' misrepresentations. *In re VeriSign, Inc. Deriv. Litig.*, 531 F. Supp. 2d 1173, 1203 (N.D. Cal. 2007). Their losses are the decline in stock price, or deflation, that occurs when the market absorbs a corrective disclosure. *Dura*, 544 U.S. at 347. Indeed, the whole premise of

Plaintiff's action is that announcement of the Restatement was a corrective disclosure – yet, that very announcement made clear that churn was not affected. Thus, Plaintiff does not and cannot identify any misstatement or correction of Leap's churn, which vitiates any fraud claim.[8]

Turning to Plaintiff's scienter allegations below, the same problem also fatally undercuts Plaintiff's revenue fraud claim. Plaintiff argues that Leap overstated its subscribers by counting disconnected and terminated customers, from which Plaintiff declares that Leap fraudulently recognized revenue for those subscribers. *See* Compl. ¶¶ 12, 14, 67.[9] Leap's churn calculation is based, however, on a subscriber count. *See* note 3, above. Given that churn was not misrepresented, it follows that Leap's subscriber count was not overstated. Thus, in a logical nutshell, Plaintiff's revenue fraud theory is inconsistent with the alleged corrective disclosure – the Restatement itself. Not surprisingly, Plaintiff is unable to plead any cogent and compelling facts to support an inference of "scienter" based a bogus revenue fraud theory, as shown below.

C. Plaintiff Has Not Alleged Scienter Regarding Any Accounting Errors Or Material Weaknesses

1. Leap's Restatement Does Not Demonstrate Scienter

Restatements are governed by GAAP. They are defined as revisions of previously issued financial statements "to reflect the correction of an *error* in those financial statements." *See* SFAS No. 154, RJN, Exh. R, at 154-6 (emphasis added). A restatement corrects "mathematical errors" and "mistakes in the application of accounting principles" when the financial statements were prepared. *In re Interpool, Inc. Sec. Litig.*, 2005 U.S. Dist. LEXIS 18112, *15 (D. N.J. Aug. 17, 2005), *quoting* APB No. 20 (superseded by SFAS No. 154).

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[8] While Plaintiff's Churn allegations are hardly a model of clarity, Plaintiff does not appear to claim that Leap's forecasts of second and third quarter 2007 Churn were false predictions. *See* Compl. ¶¶ 120-21, 134-35. The Complaint avoids any mention of the outcome of the forecasts – presumably because they were accurate. *Compare* RJN, Exh. M (1Q07 earnings release and forecast); Exh. L (2Q07); Exh. A (3Q07). If Plaintiff was to attack the veracity of Leap's predictions, Leap would be entitled to seek dismissal under the PSLRA's Safe Harbor for forward-looking statements. 15 U.S.C. § 78u-5.

[9] Note that while the Restatement disclosed that Leap had incorrectly recognized one month of revenue after a small percentage of customers had voluntary disconnected, its does not follow that included these customers in its subscriber count. Plaintiff evidently incorrectly assumes, with no factual basis in the allegations, that how Leap counts customers and how Leap determines whether and when to recognize revenue are the all same process.

Leap's Restatement is not an admission of deliberate or knowing errors. The cases are legion within the Ninth Circuit and elsewhere that "the mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish [a culpable state of mind]." *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002).[10] As shown here, Plaintiff has failed to allege any facts showing that the accounting errors in this case were the result of any attempt to manipulate Leap's reported revenue.

Moreover, the fact that Leap's accounting errors resulted in understating its revenue in 2004 and 2005 when some of errors began sharply contradicts Plaintiff's contention that Leap manipulated its accounting in order to fraudulently inflate revenue. *See In re Bally Total Fitness Sec. Litig.*, 2006 WL 3714708, at *8 (N.D. Ill. July 12. 2006) (where "the revenue for some quarters was at times understated and losses for some quarters were at times overstated," the court will not infer scienter); *In re Interpool,* 2005 WL 2000237, at *17 (restatement that resulted in decreases in income in some years "tends to negate an inference that Defendants acted with intent to perpetuate a fraud on investors").

2. Deficiencies in Internal Controls Do Not Demonstrate Scienter

Just as the Restatement does not support an inference of fraudulent intent, neither does the mere existence of material weaknesses. "[I]t is not a violation of the securities laws to simply fail to ... provide sufficient internal controls." *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 283 (3d Cir. 1992); *Andropolis v. Red Robin Gourmet Burgers, Inc.*, 505 F. Supp. 2d 662, 683 (D. Colo. 2007) (dismissing 10(b) claim that alleged insufficient internal controls).

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[10] *See, e.g., In re Guess?, Inc. Sec. Litig.*, 174 F. Supp. 2d 1067, 1078 (C.D. Cal. 2001) ("violations of GAAP are just as consistent with the existence of an accounting problem of unknown scope as they are with intentions to hide the performance of the company"); *In re Int'l Rectifier Corp. Sec. Litig.*, 2008 U.S. Dist LEXIS 44872, *4 (C.D. Cal. May 23, 2008) ("Such volitions, even significant ones requiring large or multiple restatements, must be augmented by other specific allegations that defendants possessed the requisite mental state"); *Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1009-10 (S.D. Cal. 2000) ("Violations of GAAP or GAAS, standing alone, … provide no specific facts upon which a court can infer … state of mind"); *Rogal v. Costello*, 1992 U.S. Dist. LEXIS 22179, at *5 (N.D. Cal. 1992) ("accounting allegations" failed to satisfy Rule 9(b) where plaintiffs did not "state any factual basis for their conclusions that defendants have committed fraud in preparing their financial statements."); *Fin. Acquisition Partners LP v. Blackwell*, 440 F.3d 278, 290 (5th Cir. 2006) ("failure to follow accounting standards, without more, does not establish scienter"); *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 684 (6th Cir. 2004) ("a strong inference of scienter cannot be drawn from speculative and conclusory allegations of GAAP violations"); *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 85 (2d Cir. 1999) ("[Plaintiff]'s arguments with regard to [defendant]'s accounting irregularities … by themselves, appear to amount to allegations of 'fraud by hindsight,' which this Court has rejected as a basis for a securities fraud complaint").

To plead fraud, Plaintiff must demonstrate that Defendants had *contemporaneous* knowledge of undisclosed "material weaknesses" when Leap reported on its internal controls. *See Silicon Graphics*, 183 F.3d at 974. Plaintiff's allegations of unspecified SOX reports, "hot-lining," "short-cuts," and non-specific discussions at unspecified management meetings do not plead the existence of any material weakness, much less any Defendant's knowledge of a material weakness. Notice of possible internal control deficiencies is not equivalent to knowledge of a material weakness. As discussed above, a "material weakness" is a term of art, narrowly defined by professional auditing standards and SEC regulations. Compl. ¶ 153; AS 5, App. A7, RJN, Exh. Q, at 433 (defining "material weakness"); 17 C.F.R. § 229.308.

As Plaintiff's own allegations show, the analytical process that Leap's management went through to assess internal controls over financial reporting, including determination of the existence of any "material weaknesses" during the Class Period, was complex and required considered judgment in light of many considerations:

> Under the supervision and with the participation of our management, including our CEO and CFO, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2006 based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the criteria established in *Internal Control — Integrated Framework* our management concluded that our internal control over financial reporting was effective as of December 31, 2006.

Compl. ¶ 111. Plaintiff's allegations that there were flaws in internal controls at snapshots in time, or that SOX consultants criticized internal controls, do not demonstrate that Leap or any Individual Defendant knew of any undisclosed "material weakness" that contradicted management's considered analysis and assessment.

Moreover, the fact that Leap's independent auditor concurred in management's assessment counters Plaintiff's claim that any Defendant was hiding secret knowledge of any "material weakness." PwC audited and agreed with management's assessment that Leap's internal controls were "effective" as of year-end 2006, citing professional auditing standards and criteria. *Id.* ¶ 156. The fact that, *in hindsight*, both Leap's management and PwC were mistaken does not mean that they lied in the first place. Indeed, Plaintiff alleges no facts to support the implausible supposition that Leap and PwC conspired to hide material weaknesses, especially given Leap's disclosure of *other* material weaknesses before and during the Class Period.

The case law fully supports the self-evident proposition that a material weakness uncovered in hindsight does not support an inference of fraud. *See Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 759-60 (7th Cir. 2007) (dismissing claim that defendants "'knew' the financial controls . . . to be inadequate yet failed to disclose this to investors" when hindsight was the only basis of the proposed inference). For starters, there is no "fraud by hindsight." *Tellabs*, 127 S.Ct. at 2508 (citation omitted); *see In re Hansen,* 527 F. Supp. 2d at 1158 (C.D. Cal. 2007) (dismissing fraud claims and noting that "[p]resumably every company that issues a financial restatement because of GAAP errors will cite as a reason lack of effective controls"), quoting *In re Hypercom Corp. Sec. Litig.*, 2006 WL 1836181, *9 (D. Ariz. July 5, 2006); *In re Loudeye Corp. Sec. Litig.*, 2007 WL 2404626, *7 (W.D. Wash. Aug. 17, 2007) ("that the controls were inadequate is . . . no basis for a securities fraud claim.").

Moreover, courts also recognize that internal control issues are, foremost, matters of business management, and do not demonstrate knowledge that overall controls are defective. *See, e.g.*, *In re Westinghouse Sec. Litig.*, 832 F. Supp. 948, 979 (W.D. Pa. 1993) (internal auditor's suggestions for control improvements did not support an inference that the company knew of defective controls), *aff'd in part*, 90 F.3d 696, 711 (3d Cir. 1996); *In re Aspeon, Inc. Sec. Litig.*, 168 Fed. Appx. 836, 839 (9th Cir. 2006) (management's decision not to implement suggested changes to its accounting system did not show knowledge that internal controls were defective or financial statements misstated); *Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 433 (5th Cir. 2002) (finding "perfectly reasonable explanation for implementing [an internal control upgrade] was to improve efficiency and lower costs"); *Winer Family Trust v. Queen*, 503 F.3d 319, 333-34 (3d Cir. 2007) (documents criticizing the timeliness of management's response did not show that defendants knew or recklessly disregarded any lack of sufficient internal controls).

To the extent that Plaintiff's claim boils down to mere criticism that Leap should have done *more* to improve its internal controls, this might be an allegation of negligence, but not of securities fraud. *In re BellSouth Corp. Sec. Litig.*, 355 F. Supp. 2d 1350, 1375-76 (N.D. Ga. 2005) (allegation that company should have preformed accounting impairment review sooner suggests only negligence, not knowing misconduct); *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308, 1326 (M.D. Fla. 2002) ("breakdown of or lack of . . . internal controls might amount to negligence" but does not raise inference of scienter). Three decades ago, the Supreme Court drew the line between state regulation of the duties of corporate officers and directors and federal regulation of disclosure to investors. *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462, 479 (1977) ("Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement"). Under *Santa Fe*, it is well established that alleged mismanagement does not violate Section 10(b), and there is no duty to disclose it. *See In re Impac Mortgage Holdings, Inc. Sec. Litig.*, 554 F. Supp. 2d 1083, 1094-95 (C.D. Cal. 2008) (dismissing securities fraud claims based on alleged mismanagement of internal controls).[11] In short, neither a "material weakness" in Leap's internal controls discovered in hindsight, nor alleged mismanagement of any alleged control deficiencies support any inference of scienter.

3. SEC Filings and SOX Certifications Do Not Demonstrate Scienter.

Plaintiff misplaces reliance on the fact that various Individual Defendants signed Leap's quarterly and annual SEC filings and SOX certifications. *See, e.g.*, Compl. ¶¶ 81-82, 94-96, 114-16. As discussed in the Individual Defendants' Motion to Dismiss (at 8-10), merely signing SEC filings and/or SOX certifications provides no basis to infer that the signer knew the underlying disclosures were false and does not support an inference of scienter. *In re Int'l Rectifier Corp.*, 2008 U.S. Dist. LEXIS 44872, at *59.

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[11] *See In re Silicon Storage Tech., Inc. Sec. Litig.*, 2006 WL 648683, *23 (N.D. Cal. Mar. 10, 2006) (failure to disclose "internal mismanagement [is] not by [itself] sufficient to trigger liability under the Exchange Act"); *In re Software Publ'g Sec. Litig.*, 1994 WL 261365, *7 (N.D. Cal. Feb. 2, 1994) ("A company generally bears no duty to disclose inadequacies in its own management's performance to the investing public."); *Andropolis*, 505 F. Supp. 2d at 682-83 (dismissing claims for failure to disclose internal control deficiencies).

4. Access to Unspecified Internal Reports Does Not Demonstrate Scienter

Again, to plead scienter, Plaintiff must allege facts demonstrating that each Defendant who allegedly made a false statement possessed *contemporaneous* contrary information. *Lipton v. PathoGenesis Corp.*, 284 F.3d 1027, 1036 (9th Cir. 2002). To the extent that Plaintiff attempts to meet this pleading burden by pointing to the alleged Minutes Reports, Reconciliation Reports, and SOX Testing Reports, the allegations are fatally deficient. Internal reports are ubiquitous in public companies; accordingly, Plaintiff is obliged to allege specifics about any report on which they rely.[12] Plaintiff must identify the report, plead facts demonstrating each Defendant's possession of it, and explain how the report contradicts each Defendant's contemporaneous public statements. *Id.*; *Silicon Graphics*, 183 F.3d at 984-85 (where a complaint "purports to rely on the existence of internal reports [it must] contain at least some specifics from those reports as well as such facts as may indicate their reliability"); *Alaska Elec. Pension Fund v. Adecco S.A.*, 434 F. Supp. 2d 815, 831 (S.D. Cal. 2006), *aff'd by*, 256 Fed. App. 74 (9th Cir. 2007) (plaintiffs failed to allege "details as to the information provided" in alleged reports, including "facts indicating . . . the reserves were too low or uncollectible receivables should have been written [off] earlier").

Here, Plaintiff does not specifically identify a single report provided to any Defendant, or explain how any such report would expose any misrepresentation of Leap's financial statements or internal controls. Plaintiff does not even allege that the reports revealed any accounting errors that Leap actually identified in the Restatement. Instead, Plaintiff contends that the reports demonstrated some other errors attributable to a purported overstatement of subscribers nowhere reflected in Leap's public disclosures or Restatement. Clearly, these mysterious reports cannot support a "strong inference" of fraudulent intent against any Defendant.

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[12] *See In re Vantive Corp.*, 283 F.3d at 1088 (allegations of "negative internal reports" are not sufficient to allege scienter); *In re Silicon Graphics*, 183 F.3d at 985 (alleged Flash Reports" and "Monthly Financial Statements/Packages" do not give rise to a strong inference of scienter); *In re Lockheed Martin Corp. Sec. Litig.*, 272 F. Supp. 2d 944, 956 (C.D. Cal. 2003) (allegations that defendant "received regular updates regarding the status of the Company's major projects" are insufficient to allege scienter).

5. The Confidential Witnesses Do Not Demonstrate Scienter

Plaintiff's reliance on the CWs to support an inference of scienter is equally misplaced. In general, alleged statements by CWs should be viewed with skepticism. *Higginbotham*, 495 F.3d at 757 ("allegations from 'confidential witnesses' must be 'discounted' ... [u]sually that discount will be steep." "Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist."); *Central Laborers' Pension Fund v. Integrated Elec. Servs., Inc.*, 497 F.3d 546, 552 (5th Cir. 2007) (declining to credit CW allegations that "lack sufficient detail"). "To contribute meaningfully toward a strong inference of scienter … allegations attributed to unnamed sources must be accompanied by enough particularized detail to support a reasonable conviction in the informant's basis of knowledge." *In re NorthPoint Commc'ns Group, Inc. Sec. Litig.* ("*NorthPoint II*"), 221 F. Supp. 2d 1090, 1097 (N.D. Cal. 2002). Plaintiff must plead "with substantial specificity" how CWs "came to learn of the information they provide in the complaint." *In re NorthPoint Commc'ns Group, Inc. Sec. Litig.* ("*NorthPoint I*"), 184 F. Supp. 2d 991, 991-1001 (N.D. Cal. 2001). "The Court must be able to tell whether a confidential witness is speaking from personal knowledge[.]" *In re Metawave Commc'ns Corp. Sec. Litig.*, 298 F. Supp. 2d 1056, 1068 (W.D. Wash. 2003).

Plaintiff's CW allegations suffer from multiple failings. One, based on their alleged job descriptions and tenures, some of the CWs were in no position to have the information or communications attributed to them. Two, Plaintiff intermingled its own contentions with the alleged CW comments, so that it is impossible to discern what the CWs supposedly said versus what Plaintiff infers, concludes, and argues. *See* Compl. ¶¶ 10, 11, 14, 25, 45-49, 67. Stripped of Plaintiff's contentions, the alleged work of the CWs indicates that Leap was trying to produce accurate financial reports, not to defraud investors. Three, the CW comments suffer the same vagueness as Plaintiff's allusions to internal reports. Even crediting the CW allegations at face value, nothing they say shows that any Defendant was informed of any material revenue overstatement or material weakness in internal controls.

CW#1: CW#1 allegedly worked as an information technology ("IT") consultant for four months in 2005, long before the alleged Class Period. During his brief tenure, he allegedly was asked to examine "integration issues" between the "Provisioning" and "Billing Systems" and to create "Minutes Reports" showing subscriber usage. *Id.* ¶¶ 10, 45. Plaintiff claims that "[t]hroughout 2006 and 2007" CW#1 reported to the "Management Defendants" that "short-cuts" in the porting process were creating discrepancies in the Minutes Reports resulting in subscriber and revenue overstatements. *Id.* ¶ 67.

These allegations are not credible: CW#1 was not even employed by Leap in 2006 and 2007. Nor is it plausible that a short-term IT consultant would be conversing with senior executives about "discrepancies" in usage reports (especially since minutes do not matter). Plaintiff gives no reason to suppose that CW#1 had any involvement whatsoever in Leap's determination of subscriber totals or revenue. *See Zucco Partners, LLP v. Digimarc Corp.*, 445 F. Supp. 2d 1201, 1205-8 (D. Or. 2006) (discounting statements of CWs who were not employed during the relevant period); *Kuehbeck v. Genesis Microchip, Inc.*, 2005 WL 1787426, *6 (N.D. Cal. July 27, 2005) ("field application engineer [] manager" may know of engineering department cost problems, but not of how a company reports financial information).

CW#2: Plaintiff alleges that CW#2 was a consultant to Leap from 2006 through 2008 and discovered that "subscriber account managers" were delaying "hot-lining" customers who had been terminated or disconnected. Compl. ¶¶ 46, 71. Plaintiff alleges that CW#2 found "improper practices of revenue recognition" and "discrepancies between revenue recognized, airtime usage and the Company's bank account for cash receivables." *Id.* ¶ 46. Plaintiff alleges that CW#2 reported these matters to the Management Defendants and others in unspecified communications, but offers no details whatsoever regarding these supposed communications. *Metawave*, 298 F. Supp. 2d at 1068, 1073-74 (rejecting CW allegations that failed to plead dates of alleged meetings, attendees, or the substance discussed).

As discussed above, Plaintiff does not identify any instance of hot-lining, or attempt to tie "hot-lining" to any correction of accounting errors in the Restatement which, as also noted, had no effect on Leap's churn or customer count, Compl. ¶ 139; note 5, above. Plaintiff gives no reason to suppose that any identified "discrepancies" in cash receivables were left unadjusted or resulted in misreported financial statements, or that CW#2 had personal knowledge of revenue recognition or subscriber counts. *Metawave*, 298 F. Supp. 2d at 1068 (plaintiffs must plead with "substantial specificity" how CWs came to learn of the information they allegedly provide).

CW#3: Plaintiff alleges that CW#3 was an accounting and auditing consultant in 2006 through early 2008 that found "discrepancies" and "inconsistencies" between "service revenues and subscriber airtime usage, as reflected in the "Minutes Reports," and "discrepancies between recognized revenue and the 'cash' actually received for the provision of services." *Id.* ¶ 47. CW#3 alleges that these unspecified "discrepancies" were communicated to Defendants Hutcheson and Burton at "mid-month review and at month-end pre- and post-close meetings" during 2006 and 2007 (*id.* ¶¶ 47, 68), to PwC, and to an accounting manager who supposedly reported them to the Audit Committee. *Id.* ¶ 47. Plaintiff does not identify any specific "discrepancies," or provide any specific information to demonstrate that any "discrepancies" went unadjusted or conflicted with Leap's publicly filed financial statements. Nor does Plaintiff identify any alleged communications between CW#3, the Audit Committee, its members, or any other Defendant. Stripped of Plaintiffs' conclusory spin, CW#3 appears merely to have been engaged in assisting Leap's efforts to produce accurate financial reports.

CW#4: Plaintiff claims that CW#4 was an outside consultant who worked at Leap for five months in 2006. CW#4 allegedly found "short-cuts," reported the alleged practice to Defendant Burton, along with other criticisms of Leap's internal controls. *Id.* ¶ 48. CW#4 purportedly uploaded monthly "internal controls" assessments to the Oracle Accounting Database "to be disseminated" to the Management Defendants. *Id.* These allegations are vague and unparticularized, as previously discussed.

CW#5: Plaintiff alleges that CW#5 was a consultant who worked at Leap for about three months from late 2006 to early 2007. *Id.* ¶ 49. In performing SOX compliance testing, CW#5 allegedly "found material deficiencies and weaknesses in the internal controls and reporting." *Id.* He allegedly tested "Minutes Reports," found that "managers had improperly deferred removal of subscribers who had terminated service," and concluded that "this misconduct rendered [Leap] non-compliant with SOX rules." *Id.* Plaintiff does not identify what "SOX rules" CW#5 was referring to (and none exist). Plaintiff alleges no basis to infer that CW#5 had personal knowledge of how Leap recorded revenue or determined the subscriber count. These allegations lack foundation and particularity and do not support scienter. *See Tripp v. IndyMac Fin., Inc.*, 2007 WL 4591930, *3 (C.D. Cal. Nov. 29, 2007) (rejecting beliefs of confidential witnesses because plaintiffs "failed to allege that the individual Defendants shared these beliefs … or even that they were aware of them and found them to be reliable and justified").

6. Undisputed Allegations Negate Any Inference of Scienter

Under *Tellabs*, this Court must consider "competing inferences" and "non-culpable explanations" urged by Defendants that may be "rationally drawn" from the allegations and from matters incorporated by reference or subject to judicial notice. 127 S.Ct. at 2504-05. Not only has Plaintiff failed to plead any "strong inference" of scienter, the allegations support a contrary inference that Leap prepared its financial reports honestly and good faith. Among other things:

- The Restatement followed a management-led internal review of service revenue which is inconsistent with a desire to conceal improper accounting. *See Higginbotham*, 495 F.3d at 758 (the company's decision to conduct an investigation "demonstrat[ed] a pursuit of truth rather than reckless indifference to the truth").
- The accounting errors understated revenues in some periods, which counters an inference of scienter (*Bally Total Fitness*, 2006 WL 3714708, *8), and is consistent with Leap's report that the errors were not the result of any employee misconduct.
- Leap's disclosure of material weaknesses counters any inference that Leap would deliberately hide disclosure of *other* material weaknesses. *See In re Bearing Point, Inc. Sec. Litig.*, 525 F. Supp. 2d 759, 769 (E.D. Va. 2007) ("truthful disclosures of negative information militate against a finding that [defendants] acted with a culpable state of mind").
- The fact that Leap hired outside consultants to analyze and report on account reconciliations, test internal controls, and report their findings, is inconsistent with fraudulent intent to hide improper accounting or material weaknesses. *See PR Diamonds, Inc.*, 364 F.3d at 691 (company's decision to hire a consultant to investigate internal control problems "counters an inference that the [defendants] were trying to keep the alleged accounting problems hidden").

- Leap's auditor, PwC, audited Leap's financial statements and assessment of internal controls, and concurred in them. *In re Intelligroup Sec. Litig.*, 527 F. Supp. 2d 262, 348 n. 63 (D.N.J. 2007) ("[A] 'clean' outside audit provides certain grounds for Defendants' placid state of mind and advocates against [an] inference of scienter."); *Stavroff v. Meyo*, 1997 WL 720475, *6 (6th Cir. Nov. 12, 1997) ("reliance on the guidance of outside auditors is inconsistent with the intent to defraud."); *SEC v. Caserta*, 75 F. Supp. 2d 79, 94-95 (E.D.N.Y. 1999) ("Good faith reliance on the advice of an accountant ... has been recognized as a viable defense to scienter").

7. Plaintiff Has Not Pled Corporate Scienter

"A defendant corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter, i.e., knows that the statement is false, or is at least deliberately reckless as to its falsity, at the time that he or she makes the statement." *In re Apple Computer Sec. Litig.*, 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002) (citing *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1435-36 (9th Cir. 1995). To hold Leap answerable under Section 10(b), Plaintiff must plead scienter on the part of an Individual Defendant. *In re Infineon Techs. AG Sec. Litig.*, 2006 WL 2925680, at *3 (N.D. Cal. Sept. 11, 2006) (failure to plead scienter against an individual "necessarily means … fail[ure] to plead scienter with respect to the [corporate] defendants."); *In re Invision Techs., Inc. Sec. Litig.*, 2006 U.S. Dist. LEXIS 12166, at *22-23 (N.D. Cal. Jan. 24, 2006) (same). As shown here and in the Individual Defendants' Motion to Dismiss, Plaintiff has failed to do so and, therefore, failed to plead scienter against Leap.

IV. CONCLUSION

For the reasons above and in the Motion to Dismiss filed on behalf of the Individual Defendants, Leap respectfully requests dismissal of the Consolidated Class Action Complaint.

Dated: August 28, 2008

Respectfully submitted,

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